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The Manufacturers Hanover
Economic Report

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Business Conditions Update

The surge in stock prices since late August has given rise to hopes that the U.S. economy may at last be on the verge of breaking out of its protracted slump. Although its record as a forecaster of downturns is checkered, the stock market has not failed to anticipate a business recovery during the postwar era. In my opinion, a good case can be made that this time will be no exception. However, I would question the strength and duration of the business upturn, when it develops. For while the conditions that produced what may well turn out to be the worst recession since the 1930s may have been alleviated somewhat, they have not been eradicated altogether. What is more, they could worsen well before the end of next year, suggesting the possibility of renewed recession, inflation—or both.

Few Signs of Recovery ...

The rally on Wall Street has been greeted with more than the usual degree of skepticism. To the uninitiated, the stock market seems to be marching to the beat of a different drummer than the real economy. While the popular market averages have climbed by about a third since late August, there are few, if any signs that the real economy has stopped weakening—much less begun to strengthen. Businesses continue to fold up at rates not seen since the 1930s, producing the highest level and rate of unemployment since just before World War II. Compared with an average decline of 10.3 percent in each of the seven postwar recessions, industrial production is off 11 percent so far with every category down except defense. Capacity utilization at the end of the third quarter dropped to 69.1 percent—about equal to the postwar low of 69 percent reached in the depths of the 1973-75 recession.

Looking at the broader-based gross national product figures produces just as bleak a picture. While the real GNP rose by 0.8 percent in the third quarter of 1982 after increasing 2.1 percent in the second, real sales to final consumers decreased 0.6 percent in the third quarter after a decline of 0.9 percent in the second quarter. In other words—with the exception of an $800 million rise in the first quarter this year, sales to final consumers adjusted for inflation have been falling since summer 1981.

There were declines in at least part of each major gross national product category. While consumer spending rose $3.4 billion in the third quarter, after factoring out inflation, purchases of durable goods decreased by $1.5 billion. Business spending fell on all fronts. Real nonresidential fixed investment decreased $5.7 billion in the third quarter after falling $5.3 billion in the second. Nonresidential construction outlays decreased by $1.2 billion after virtually stabilizing in the second quarter and there was a hefty decline of $4.5 billion in producers durable equipment purchases in the third quarter following an even bigger decrease of $5.5 billion in the second quarter. Reflecting the combination of an overvalued dollar and recessions abroad, exports decreased by $4.2 billion in real terms while imports rose by almost $1 billion.

In one category of business spending there was a rise—but this is not good news. Inventories increased by $700 million in the third quarter, following decreases of $4.4 billion in the second and $15.4 billion in the first. Because of the way the National Accounts are put together, a change from inventory liquidation to inventory accumulation adds to the GNP (in this case, $5.1 billion) but this can hardly be considered a sign of strength, in view of the protracted decline in final sales.

Apparently the largest accumulation of inventories occurred at the wholesale and retail levels. Earlier in the quarter, merchants were preparing for an upturn in sales. They usually pick up toward the end of the summer—and this time hopes were bolstered by the July 1 tax cut and increase in Social Security benefits. But as demand fell below expectations, inventories soared. If sales continue weak in the current quarter, wholesalers and retailers will slice orders—instead of increasing them, as they usually do this time of year—and this will mean further cutbacks in production and increases in layoffs.

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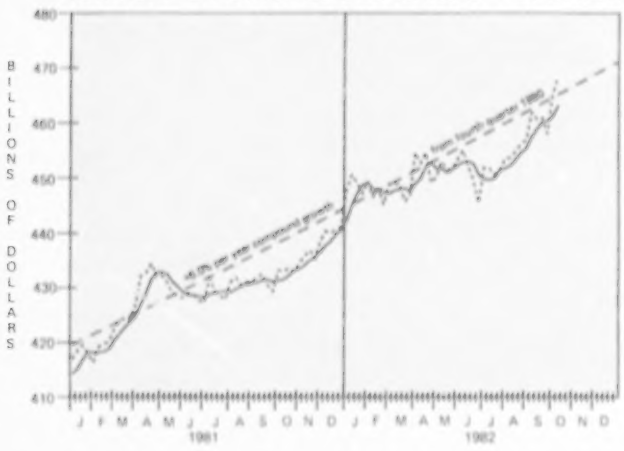
But the rise in the stock market offers some hope that the coming holiday buying season may mark the beginning of a pickup in consumer spending. The recent rally caused the value of stocks in the hands of the nation's 32 million individual stockholders to jump by close to $200 billion. Add to this another $50 billion increase in the value of Treasury securities held by the public and you have an increase in consumer wealth of at least $250 billion in barely two months' time. That is equal to the rise in total personal incomes that took place in the entire year 1981! Plainly, this much of an increase this soon is bound to lead to some increase in consumer spending. The literature suggests that when consumers believe they are wealthier, they will spend more. How much will depend on a variety of factors not the least of which is confidence.

CHART I
MONEY SUPPLY, M1
FOUR-WEEK MOVING AVERAGE (LINE) VS. WEEKLY FIGURES (DOT)



A rise in the stock market such as was experienced over the past couple of months is enough to make some people at least a little bit more optimistic. But this will not translate into greater rates of spending for the non-shareholders until their own personal experience confirms it. And an even longer period of time will be necessary before higher stock prices translate into increased business spending—notwithstanding the decline in the cost of obtaining funds that a rising stock market brings. Executives will need a greater inflow of orders and a much higher rate of capacity utilization before they begin to think about increasing spending for new factories, office buildings, machinery and equipment.

Another reason why the stock market rally has been denigrated is that it seems to have occurred largely because of what the markets believe to be a change in Federal Reserve monetary policy—not because of any fundamental change in business conditions. There is a widespread belief on Wall Street that the Federal Reserve has eased monetary policy, whether you look at it from the point of view of the monetarists or the Keynesians. Monetarists look at the growth of money and credit and since midyear the money supply M1 has shot up at about a 14 percent annual rate compared with virtually no growth at all during the previous six months. Keynesians look at interest rates, and since midyear short-term interest rates have dropped by as much as seven percentage points, while long-term rates have fallen by about 4½ points.

Of course, both money supply growth rates and interest rates have gyrated significantly since October 6, 1979, when the Federal Reserve switched to a monetarist-oriented monetary policy. So for the stock market to have rallied the way it did, it had to be convinced that this was more than just simply another zigzag. Investors apparently concluded that the combination of a much-reduced rate of inflation, growing strains in the financial system, and the protracted weakness in economic activity finally persuaded the central bank to change the focus of its monetary policy from fighting inflation to fighting recession.

Notwithstanding the rise in the stock market, there remains a considerable difference of opinion over whether the Federal Reserve has really changed its policy. To be sure, the public statements of various Federal Reserve officials have sought to minimize the significance of any policy change, calling it "technical in nature with zero policy significance." This is no doubt designed to assuage the fears of those who believe that, left unchecked, current rates of money growth could dissolve into a new round of inflation psychology and ultimately sharply rising prices. Yet the facts are that there has been a considerable degree of expansion in money and credit since midyear and a sizable drop in interest rates, so those who believe that the Fed has executed a policy shift may not be entirely wrong.

Whether the Fed has changed policy or not, investors in equities believe it did and that's why they jumped into the stock market. Such a development is not unusual at this point in the business cycle. Studies show that changes in the direction of interest rates do have a significant bearing on stock prices. As interest rates fall, stocks become more attractive—especially to institutional investors who have sizable amounts of money coming in constantly that must be invested prudently, in relatively liquid instruments, and in markets that they will not overwhelm by sheer size. Conversely, when interest rates rise, these funds are pulled out of equities because fixed-income securities offer more competitive rates of return.

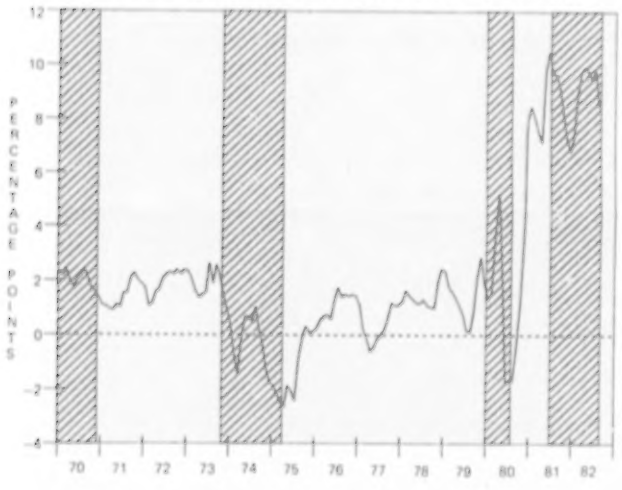
... But A Modest Upswing ...

Whether stocks hold all of their gains or not, I would think that the economy will strengthen a bit in the near future—if it has not already done so. This is because interest rates charged on a variety of loans to consumers have joined those that business pays in declining. While lower interest rates will not reduce the

monthly payment on automobiles by very much, they might have a psychological effect, spurring sales of new cars. The same might be said for other types of consumer loans. The impact of swings in interest rates is greatest when it comes to homebuying, and here, the decline in mortgage interest rates that has already taken place has increased the percentage of households that can theoretically afford to buy a house from its low of 15 percent in March to nearly 20 percent today.

Another factor that will help the recovery is the much slower rate of inflation. Buying power (after-tax income adjusted for inflation) is rising on an annual basis—as has been the case since the middle of 1980. It is growing faster than rates that prevailed at the conclusion of the 1980 recession as well as the end of the 73-75 recession. Inflation is likely to remain at or below the five to six percent zone for the next year or so for a variety of reasons. Commodities prices are off some 20 to 30 percent from their recent peaks, one-third of American capacity is lying idle, the unemployment rate, of course, is at a postwar high—and, notwithstanding the recent surge in money growth, over a two-year period the money supply has not expanded all that rapidly (Chart I). As consumers see that they can afford to spend and/or borrow to buy goods, their pent up demands for such items as cars and houses will take over and produce improved sales in these two important categories. Meanwhile, spending on services, small ticket hardgoods and softgoods is likely to remain firm.

CHART II
SPREAD BETWEEN PRIME RATE AND INFLATION RATE



However, none of this really adds up to a typical business cycle recovery, where the real gross national product in the first year of the upswing would grow by rates of six percent or more. The way I see it, it boils down to one reason: Interest rates are still historically high when compared with inflation. As you can see from the next two charts (Charts II and III), interest rates on short-term business loans as well as those in the bond markets may have fallen considerably from their peaks of 1981-1982, but when compared with inflation, they still remain historically high. Indeed, before they fell, real interest rates were at their highest levels since the early 1930s. You will notice that in the 1973-73 recession, and again toward the end of the 1980 recession, real long- and short-term interest rates turned negative—that is, they were below the 12 month rate of inflation at that time. Those levels of interest rates provided great incentive for people to borrow to buy new cars, houses and other major items. It was also an incentive for business to borrow in order to expand its pace of operations and its ability to produce.

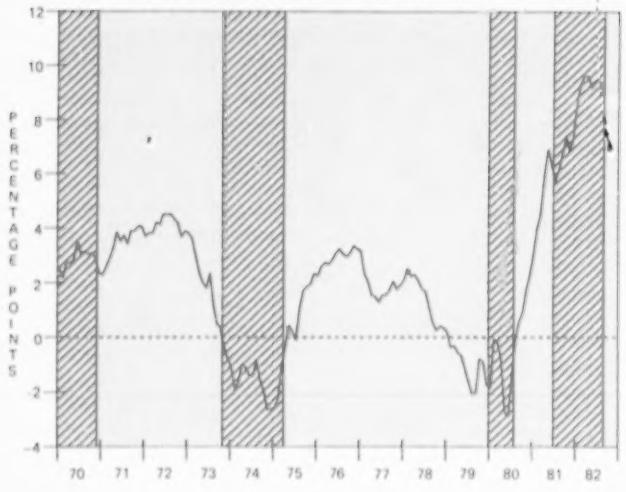
. . . Seems Likely To Occur

Today's comparatively high real rates of interest will serve to retard the economic recovery. High real interest rates are a deterrent to borrowing and an incentive for saving. High real interest rates will keep the dollar in its overvalued position by discouraging exports and promoting imports. Unless and until real interest rates descend to more "normal" levels, they will act as a brake on the economic recovery.

The question might occur why did interest rates break their historic relation with inflation in the first place. No one knows with any certainty, but it seems to me to trace to several recent developments. The greater volatility of both interest rates and the money supply following the Federal Reserve's shift to monetarism three years ago seems to have added a "volatility premium" to the level of interest rates besides the inflation premium and the "rent" premium, both of which had been embodied in interest rates for many years. In summer of 1981, another premium might have been added, one that, for lack of a better term, could be called a "fear" premium. The markets got scared in summer of 1981, when Washington revealed that the government's budget deficits were not going to get smaller and eventually disappear by mid-decade, but rather, were going to get bigger and expand into the 12-digit territory. The fear was that either these deficits and their associated borrowing requirements would overwhelm the money and credit markets, driving interest rates up in the process—or that they wouldn't; that the Federal Reserve would monetarize these deficits, but in the process, set the stage for a new round of inflation.

These last two premiums are still embodied in interest rates today—although they appear to be temporarily suppressed. Plainly, both the money supply and interest rates remain volatile, although not as much as in the period immediately following the Fed's October 6, 1979 policy switch. As for the fear premium, it is apparent that the markets fear recession, high unemployment, business failures, etc., more at the moment than they do inflation. However, this should not last too long, since, as I have pointed out above, a recovery seems to be

CHART III
SPREAD BETWEEN AA UTILITY RATE AND INFLATION RATE



getting underway. The question then becomes when will the markets change their focus from recession to inflation once again. The answer to this will determine how much longer the Fed will be able to concentrate on interest rates and money market conditions before it is forced to go back to the automatic pilot of trying to control money supply growth.

At the risk of being repetitive, I would like to point out that the Fed's ability to manage the money supply and keep interest rates down would be significantly enhanced were fiscal policy to work in tandem. Right now, as you know, there is no synchronization of fiscal and monetary policies. Monetary policy has been comparatively tight, while fiscal policy has been extremely easy and seems likely to impart even more stimulus over the near term. This Report warned two years ago (November 1980) of the consequences of cutting taxes before putting into effect offsetting reductions in outlays: "This simply will not work. Its near-term impact on the Federal government's financing needs will be devastating, since any policy that calls for more spending and less taxes—regardless of what their classroom results might be—will in the real world widen an already swollen budget deficit." The Report went on to say that bigger deficits combined with tight money will produce higher interest rates and a weak economy.

This combination of policies has been modified only slightly in recent months. As I have already observed, the monetary authorities are undoubtedly more generous with money and credit today than during the first half of 1982. And fiscal policy has been tightened a notch by the passage of the tax bill that calls for "enhancing" Federal government revenues by $100 billion over a three-year period of time. But more needs to be done if we are to continue to enjoy low rates of inflation while at the same time strengthening the private economy. I would say that the Federal Reserve has done about as much as can be expected, given our recent experiences with rapid money growth and inflation. It seems to me that more must be done on the fiscal side.

Some people—both in and out of Washington—find it hard to understand why fiscal policy must be tightened in order to get us out of this recession, whereas the conventional prescription calls for a loosening of fiscal policy. I think I have already given you the answer: When the government loosened fiscal policy, the resulting deficits came as such a shock to the markets that they moved interest rates higher to protect themselves from the consequences of greater government borrowing with or without an easier Federal Reserve monetary policy. These higher interest rates added to government costs, of course. At the same time, by remaining way above historical levels relative to inflation, these high interest rates sent the economy down and many businesses with it. That cut into government revenues and further increased government spending on unemployment benefits, food stamps, etc.

Loosening fiscal policy even more is not going to solve anything, since it will increase the budget deficit, hence the government's borrowing requirements. To repeat what I said in November 1980: "If the Federal Reserve supplies the amount of money and credit necessary to meet Washington's increased financing requirements while accomodating everyone else, inflation will undoubtedly worsen. If the Fed reverts back to a tight money policy, inflation will stay down—but so will the real private economy."

As for how to reduce the budget deficit, let me suggest that politicians of all stripes have great difficulty appearing before their constituents asking for their vote while cutting spending on projects that benefit them. If spending cannot be reduced then taxes must be increased—and the ones I have in mind fall under the heading of the Economic Recovery Tax Act (ERTA) of 1981. Originally designed to be a revenue raiser, ERTA, by the Administration's own admission, has become a revenue loser.

We would all like the burden of government to be reduced, but as this Report said last month, "the true burden of government is reduced, not just by cutting taxes, but by lowering spending as well. If taxes are reduced and spending is not, the burden is just as onerous as it was before, if not more so." Washington gets money to spend in one of three ways: It borrows from the Federal Reserve, from the private sector, and it taxes. We have seen what happens when too much emphasis is placed on borrowing from the Fed: Inflation. In recent months, Washington has borrowed mainly from the private sector: That has produced recession. Isn't it about time we tried the third route: Taxes? After all, we as individuals are ultimately constrained by our incomes; why should we expect any less of our government?

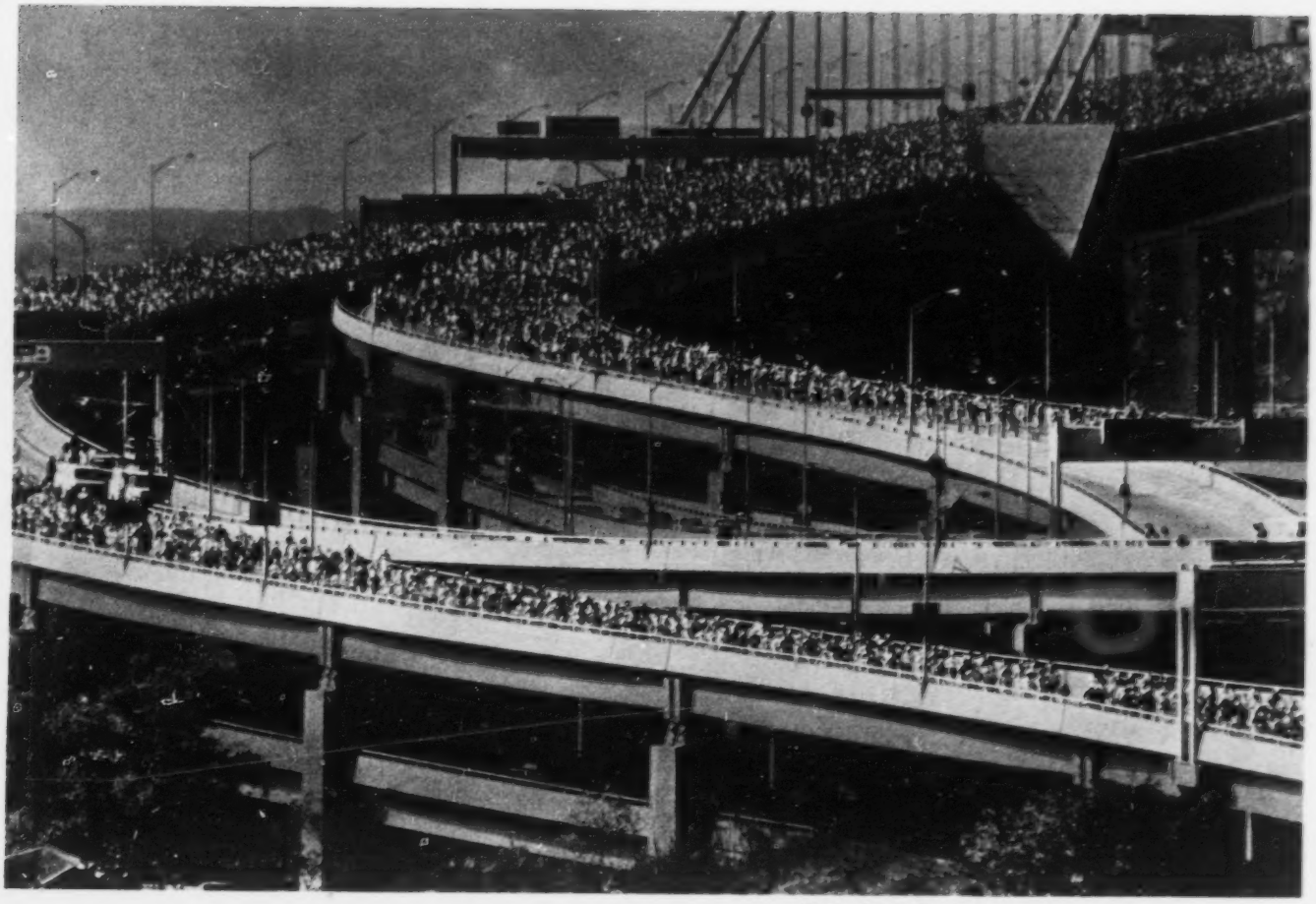
October, 1982

MHT FORECAST OF GROSS NATIONAL PRODUCT

(Seasonally Adjusted Annual Rates)

In $ Billions

			< Actual			Projected >								
	YEAR 1981		1982				YEAR 1982		1983				YEAR 1983	
	LEVEL	% CH	I	II	III	IV	LEVEL	% CH	I	II	III	IV	LEVEL	% CH
Gross National Product	**2937.7**	**11.6**	2995.5	3045.2	3091.4	3152.2	**3071.1**	**4.5**	3219.4	3285.9	3355.5	3437.0	**3324.5**	**8.3**
GNP: $72	**1502.6**	**1.9**	1470.7	1478.4	1481.2	1489.9	**1480.0**	**−1.5**	1499.8	1511.3	1522.6	1535.7	**1517.3**	**2.5**
% Change, Annual Rates	**1.9**		−5.1	2.1	0.8	2.4	**−1.5**		2.7	3.1	3.0	3.5	**2.5**	
Consumption	**1843.1**	**10.6**	1919.4	1947.8	1989.5	2026.5	**1970.8**	**6.9**	2067.0	2109.7	2155.0	2201.9	**2133.4**	**8.3**
Durables	**234.5**	**9.4**	237.9	240.7	240.6	249.6	**242.2**	**3.3**	254.9	263.8	272.8	282.3	**268.5**	**10.8**
Non-Durables	**734.5**	**9.6**	749.1	755.0	770.8	777.5	**763.1**	**3.9**	790.0	800.4	812.6	824.9	**807.0**	**5.7**
Services	**874.1**	**11.7**	932.4	952.1	978.1	999.4	**965.5**	**10.5**	1022.1	1045.4	1069.6	1094.6	**1058.0**	**9.6**
Investment	**471.5**	**17.2**	414.8	431.5	438.5	438.0	**430.7**	**−8.7**	456.7	472.1	489.9	509.1	**482.0**	**11.9**
Non-Residential	**346.1**	**12.0**	357.0	352.2	341.6	334.6	**346.4**	**0.1**	336.5	340.8	349.5	360.0	**346.7**	**0.1**
Producers Durable Equipment	**216.4**	**8.9**	215.6	208.6	201.0	198.3	**205.9**	**−4.9**	201.4	206.3	212.9	220.3	**210.2**	**2.1**
Structures	**129.7**	**17.4**	141.4	143.6	140.5	136.4	**140.5**	**8.3**	135.0	134.5	136.6	139.6	**136.5**	**−2.9**
Residential	**105.0**	**1.7**	93.4	95.5	97.4	107.3	**98.4**	**−6.2**	116.8	124.1	130.3	136.3	**126.9**	**29.0**
Inventory Changes	**20.4**		−35.6	−16.2	−0.5	−3.9	**−14.1**		3.4	7.2	10.2	12.8	**8.4**	
Net Exports	**26.1**		31.3	34.9	13.2	18.6	**24.5**		22.0	19.1	16.8	19.6	**19.4**	
Government Purchases	**597.0**	**10.9**	630.1	630.9	650.2	669.1	**645.1**	**8.1**	673.7	685.0	693.8	706.3	**689.7**	**6.9**
Federal Defense	**153.7**	**17.0**	166.2	176.2	183.7	191.7	**179.5**	**16.7**	195.6	199.9	202.1	210.9	**202.1**	**12.6**
Federal Civilian	**75.2**	**14.3**	83.5	68.2	73.9	78.4	**76.0**	**1.0**	76.9	76.3	77.4	77.1	**76.9**	**1.2**
State & Local	**368.0**	**7.8**	380.4	386.6	392.6	399.1	**389.7**	**5.9**	401.2	408.9	414.3	418.4	**410.7**	**5.4**
Final Sales: $72	**1493.7**	**1.0**	1486.1	1482.7	1480.6	1491.4	**1485.2**	**−0.6**	1498.3	1508.2	1518.5	1530.7	**1513.9**	**1.9**
% Change, Annual Rates	**1.0**		0.2	−0.9	−0.6	3.0	**−0.6**		1.8	2.7	2.8	3.2	**1.9**	
GNP Price Index (1972 = 100)	**195.5**	**9.4**	203.7	206.0	208.7	211.6	**207.5**	**6.1**	214.7	217.4	220.4	223.8	**219.1**	**5.6**
% Change, Annual Rates	**9.4**		4.3	4.6	5.4	5.6	**6.1**		5.9	5.3	5.5	6.4	**5.6**	
PCE Deflator (1972 = 100)	**194.5**	**8.6**	202.2	204.0	207.6	209.8	**205.9**	**5.9**	212.8	215.6	218.5	221.5	**217.1**	**5.4**
% Change, Annual Rates	**8.6**		4.9	3.6	7.2	4.4	**5.9**		5.8	5.3	5.5	5.5	**5.4**	
Consumer Price Index (1967 = 100)	**272.4**	**10.3**	283.6	286.8	292.1	294.1	**289.1**	**6.1**	298.1	302.2	306.4	310.7	**304.4**	**5.3**
% Change, Annual Rates	**10.3**		3.2	4.6	7.6	2.7	**6.1**		5.6	5.6	5.7	5.7	**5.3**	
Total Personal Income	**2415.8**	**11.8**	2510.4	2552.5	2597.9	2638.3	**2574.8**	**6.6**	2688.1	2742.9	2806.7	2873.5	**2777.8**	**7.9**
Disposable Personal Income	**2029.1**	**11.2**	2117.1	2151.5	2202.3	2236.5	**2176.8**	**7.3**	2274.6	2320.4	2393.8	2447.4	**2359.0**	**8.4**
Savings Rate	**6.4**		6.6	6.7	6.9	6.6	**6.7**		6.4	6.3	7.2	7.3	**6.8**	
Employment Rate	**58.8**		57.9	57.8	57.7	57.5	**57.7**		57.6	57.9	58.1	58.4	**58.0**	
Unemployment Rate	**7.6**		8.8	9.5	9.9	10.3	**9.6**		10.2	9.9	9.8	9.6	**9.9**	
Indus. Production (1967 = 100)	**150.9**	**2.6**	141.8	139.4	138.1	137.5	**139.2**	**−7.8**	139.9	142.2	144.5	147.6	**143.5**	**3.1**
Housing Starts (000)	**1099.8**	**−15.3**	920.3	952.0	1113.7	1149.3	**1033.8**	**−6.0**	1227.4	1340.3	1331.0	1462.9	**1340.4**	**29.7**
Domestic Auto Sales (000)	**6216.7**	**−5.4**	5733.3	5466.7	5504.3	5736.9	**5610.3**	**−9.8**	6048.5	6165.0	6412.6	6739.7	**6341.4**	**13.0**
Corporate Pre-Tax Profits	**232.1**	**−8.3**	171.6	171.7	174.9	178.7	**174.2**	**−24.9**	184.0	192.2	198.5	208.5	**195.8**	**12.4**
− Taxes	**81.2**	**−4.1**	56.7	55.3	56.4	58.4	**56.7**	**−30.1**	64.5	67.7	69.9	73.7	**68.9**	**21.6**
Net Profits	**150.9**	**−4.4**	115.0	116.3	118.5	120.3	**117.5**	**−22.1**	119.6	124.5	128.6	134.8	**126.9**	**8.0**
− Dividend Payments	**65.1**	**12.1**	68.8	69.3	70.5	72.0	**70.2**	**7.8**	73.5	74.8	76.2	77.6	**75.5**	**7.6**
Undistributed Profits	**85.8**	**−14.0**	46.1	47.0	48.0	48.2	**47.3**	**−44.8**	46.1	49.7	52.5	57.3	**51.4**	**8.6**
+ Depreciation	**189.3**	**15.9**	208.8	216.5	223.8	234.3	**220.8**	**16.6**	246.1	253.6	261.4	268.8	**257.5**	**16.6**
− Inventory Profits	**24.6**	**−42.8**	4.4	9.4	11.4	3.3	**7.1**	**−71.0**	8.2	13.1	14.3	16.5	**13.0**	**82.5**
Net Cash Flow	**250.6**	**13.8**	250.5	254.1	260.4	279.2	**261.0**	**4.2**	284.0	290.3	299.6	309.6	**295.9**	**13.3**



The New York City Marathon, co-sponsored by Manufacturers Hanover

The marketplace demands sustained effort.

Manufacturers Hanover strives.

Winning a 26.2 mile marathon takes planning, positioning, and endurance. And in much the same way, Manufacturers Hanover's planning, positioning, and willingness to accept challenges are paying off significantly.

For example, our subsidiaries now have more offices nationwide than any other bank holding company, giving us instant access to both large and middle market companies. This enables us to provide other financial services besides banking—factoring, equipment financing, and mortgage lending.

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